STATE OF CALIFORNIA
CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE
915 CAPITOL MALL, ROOM 485
SACRAMENTO, CA 95814
TELEPHONE: (916) 654-6340
FAX: (916) 654-6033

Jeanne L. Peterson
Executive Director

A DESCRIPTION OF CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE PROGRAMS

The California Tax Credit Allocation Committee ("Committee" or "TCAC") administers two low-income housing tax credit programs -- a federal program and a state program. Both programs were authorized to encourage private investment in rental housing for low -and lower-income families and individuals.

The Committee

The Committee has seven members, three voting members and four advisors. The voting members include the State Treasurer, who serves as chairman, the State Controller, and the Governor, who may choose to have the Director of the Department of Finance represent him or her on the Committee.

The non-voting members are the Executive Director of the California Housing Finance Agency, the Director of the Department of Housing and Community Development, and two representatives from local government. One local representative must be associated with a city and is appointed by the Speaker of the Assembly. The other member is a county representative appointed by the Senate Rules Committee.

The Federal Program

Congress authorized the federal program ("Credit program") in 1986. It replaced traditional housing tax incentives, such as accelerated depreciation, with a tax credit that enables low-income housing sponsors and developers to raise project equity through the sale of tax benefits to investors.

The Credit program is contained in the federal tax code and is administered by the Internal Revenue Service, which is part of the U.S. Treasury Department. Internal Revenue Code Section 42 specifies that, in each state, the state legislature designates the "housing credit agency" to administer the Credit program. In California, responsibility for administering the program was assigned to the California Tax Credit Allocation Committee, first by a February 1987 gubernatorial proclamation, and later by enactment of SB 113, Chapter 658, Statutes of 1987.

The federal tax credit was granted permanent status with passage of the Omnibus Budget Reconciliation Act of 1993. Prior to receiving permanent program status, Congress authorized the Credit program on an annual basis.

The State Program

Recognizing the high cost of developing housing in California, the legislature authorized a state low income housing tax credit program to augment the federal tax credit program. Authorized by Chapter 1138, Statutes of 1987, the state credit is only available to a project which has previously received, or is concurrently receiving, an allocation of federal credits. The state program does not stand alone, but instead, supplements the federal tax credit program.

Annual Federal Credits Available

Each state is allowed an annual housing credit ceiling of $1.25 per capita, and may qualify for a prorata share of credits available annually in a national pool comprised of states' unused credits. Also, any credits returned to a state from a credit recipient can be allocated to new projects. From the total ceiling amount available to California, the Committee allocates credit amounts based upon assessments of eligible project costs, as defined by IRC Section 42. The housing sponsor uses or sells ten times the allocation amount, since investors can take the annual credit each year for a ten-year period. Although the credit is taken over a ten-year period, the Internal Revenue Code requires that the project remain in compliance for at least 15 years.

Annual State Credits Available

The annual state credit ceiling is currently set at $35,000,000 annually (in addition to any unused or returned credits from previous years).

Investors take the state credit over a four-year period in contrast to the ten-year federal allocation period. The full four-year state credit allocated to a project is deducted from the ceiling, while only the annual federal credit allocated to a project is deducted from the federal ceiling.

Eligible Projects

Only rental housing projects are eligible for tax credits in both the federal and state programs. Credits can be allocated to new construction projects or projects undergoing rehabilitation. Credits are allocated on a competitive basis so that those meeting the highest housing priorities, as determined by the Committee, have first access to credits. Those utilizing tax credits must own the project for which the credits are awarded. Tax credits are allocated based on the cost basis of the project, including hard and soft development costs associated with building the project, but not including land costs and other non-depreciable items.

Rent and Income Restrictions

The Credit program has both rent and income restrictions. Since 1990, rents on tax credit units cannot exceed 30% of an imputed income based on 1.5 persons per bedroom (i.e., in a two-bedroom unit, the income of a three-person household is used to calculate rent, regardless of the actual family size of the household). For projects allocated credits before 1990, rents must be at or below 30% of the qualifying income of the household occupying a unit.

Federal law requires that the initial incomes of households in tax credit units cannot exceed either 60% or 50% of the area median income, adjusted for household size. When a project developer or sponsor applies for tax credits, he or she irrevocably elects one of the following minimum federal set-aside requirements:

- a minimum of 40% of the units must be both rent-restricted and occupied by households whose incomes are 60% or less of the area median gross income, adjusted for family size, or

- 20% of the units must be both rent-restricted and occupied by households whose incomes are 50% or less of the area median gross income, adjusted for family size.

Despite this minimum set-aside election, project sponsors often designate all of the units in a project for occupancy by low-income households, since credits are allocated only for restricted units. For instance, if a developer builds a project in which half of the units are market-rate and half are affordable, only half of the eligible project costs would be considered when determining how much credit may be allocated. Additionally, as described below, sponsors generally target a certain number of units to tenants with incomes below 60% or 50% of median to compete successfully.

Long Term Affordability

Under federal law, credit projects must remain affordable for at least 15 years; however, California law generally requires a 55 year compliance period. Regulatory agreements are recorded against each credit project to ensure compliance.

Determination of Credit Need

As required by federal law, the Committee performs feasibility analyses on every project to ensure that allocations do not exceed the amount required for project feasibility. While a project's qualified basis determines a maximum credit allocation, only the amount needed to fill the financing shortfall can actually be allocated. The Committee must consider the sources and uses of funds and the total financing planned for the development, including the projected proceeds to be generated by the sale of tax credits. The Committee must also determine the reasonableness of estimated development, operational and intermediary costs. For each project, the amount of credits needed must be determined at least three times, at application, allocation, and placed-in-service.

How Credit Amounts Are Calculated

In determining the amount of credit for which a project may be eligible, first, total project cost is calculated. Secondly, “eligible basis” is determined by subtracting non-depreciable costs, such as land, permanent financing costs, rent reserves and marketing costs. Next, the eligible basis is multiplied by the “applicable fraction”, which is the smaller of, (1) the percentage of low income units to total units, or, (2) the percentage of square footage of the low income units to the square footage of the total units. This figure is known as the “qualified basis” of the project.

The qualified basis is multiplied by the federal tax credit rate, published monthly by the IRS, to determine the maximum allowable tax credit allocation. For projects that are new construction or rehabilitation, which are not financed with a federal subsidy, the rate is approximately 9%. For projects involving a federal subsidy (including projects financed more than 50% with tax exempt bonds), the rate is approximately 4%. A project's final (placed-in-service) tax credit allocation is based on actual project sources and uses of funds, the financing shortfall and the actual applicable federal rate. The rate applicable to a project is the rate published for the month each building is placed in service or in an earlier month elected by the sponsor. The allocation cannot exceed the initial reservation amount and may be reduced if an analysis determines that the maximum allowable amount would generate excess equity proceeds to the project.

Raising Equity Investment

Most credits are sold to corporate or individual investors through public or private syndication. Investors benefit from the tax credit by purchasing an ownership interest in one or more tax credit housing projects. In turn, investors take a dollar-for-dollar credit against their tax liability over a ten-year period. Partnership equity contributed to the project in exchange for the credit typically finances 30-60% of the capital costs of project construction.

The net amount of equity proceeds contributed to a project is based on investor contributions (the present value of the ten-year credit) less syndicator overhead and fees and other syndication-related costs. The Committee uses the net tax credit factor (net proceeds divided by the total 10-year tax credit allocation) to determine the credit amount needed.

Differences Between the State and Federal Programs

California's tax credit program was structured to mirror the federal program with certain exceptions. In addition to the state credit only being available to projects which also receive a federal credit, other differences include:

- TCAC gives priority for state credit allocations to projects not located in a designated high cost area and those using HOME funds to finance eligible costs.

- The applicable percentage to be applied to the qualified basis for determining the amount of state credits is 30% for projects which are not federally subsidized, and 13% for projects which are federally subsidized, in contrast to 9% and 4% for the federal credit.

- State credits are not available for acquisition costs, except for projects that qualify as "at-risk" of being converted to market rate.

- The state program has a rate of return limitation. Any surplus revenues generated above the limitation must be used to reduce rents.

State Credits in Designated High Cost Areas

The authorizing legislation that created the state tax credit prohibited credit allocations to projects located in federally-designated high cost areas (HCAs). The prohibition was included to recognize that additional federal credits, in amounts derived by increasing eligible basis by 130%, are awarded to projects in HCAs, and thereby reduce the need for state credits. Once the HCAs were identified, it was noted that a significant portion of the state was deemed an HCA. In response, the legislature enacted Chapter 1485, Statutes of 1990 (AB 374), allowing state credit allocations in HCAs, but only if the federal credit is not increased above 100% of eligible basis. The state credit and the federal credit may be used together up to an amount that does not exceed the amount of federal credit that would be available after increasing eligible basis to 130%.

The Qualified Allocation Plan (QAP)

State allocating agencies must each design and implement a Qualified Allocation Plan ("QAP") that establishes priorities for allocating the credit based on state and local needs. Section 42 requires allocating agencies to hold public hearings to consider public input on the QAP.

Federal law defines a QAP as a document which:

1. sets forth selection criteria to be used to determine housing priorities of the housing credit agency which are appropriate to local conditions;

2. gives preference in allocating housing credit dollar amounts among selected projects to -
   (a) projects serving the lowest income tenants, and
   (b) projects obligated to serve qualified tenants for the longest period; and,

3. provides a procedure that the agency will follow in monitoring projects for noncompliance according to the provisions of IRC Section 42 and in notifying the IRS of such noncompliance.

Section 42 also requires that the QAP include the following selection criteria:

- project location
- housing needs characteristics
- project characteristics
- sponsor characteristics
- participation of local tax-exempt organizations
- tenant populations with special housing needs
- public housing waiting lists

Title 4, Chapter 17 of the California Code of Regulations ("Regulations") also sets forth the policies and procedures governing the Committee's management of the Credit Program. In 1996, the Committee revised the Regulations to incorporate the QAP by reference.

Threshold Criteria

State law and the Committee's Regulations require that projects meet certain readiness criteria at the time an application is filed. If these are not met, an application is rejected. These criteria effectively dissuade applicants from applying too soon before they are ready to build their project. Federal law imposes unforgiving deadlines both for allocating agencies and project sponsors to meet. Failure to meet these deadlines jeopardizes the Committee's ability to allocate all credits and could cause sponsors to lose credits.

Threshold criteria require that the applicant show the following:

(a) the type of housing proposed is needed and affordable to the targeted population within the community in which it is to be located;
(c) enforceable financing commitments of at least 50% of the total estimated financing need;
(d) control of the site;
(e) compliance with all applicable local land use and zoning ordinances;
(f) development team experience and financial capacity to ensure project completion and operation for the extended use period;
(g) financial viability throughout the compliance period of the project;
(h) minimum construction standards;
(i) all deferred-payment financing, grants, and subsidies be "committed" at application; and
(j) with the exception of tax-exempt bond projects, project size is limited to no more than 200 units for non-rural set-aside applications, and 80 units for rural set-aside applications.

In addition, targeted projects must meet additional threshold requirements as applicable to the targeted population. These additional threshold requirements can be found in the Regulations.

Application Cycles and TCAC Review Process

State law requires the Committee to hold two or more application cycles each year, unless circumstances warrant a reduction in the number of cycles. The first cycle is generally held in the first few months of the year, with a second cycle following in the late spring.

Application Process

TCAC has prepared an application package that is intended to assist applicants to present clearly the characteristics of their project. Staff reviews the application to determine the reasonableness of project costs, the maximum allowable tax credit allocation, and the amount of credit needed for financial feasibility.

The application review process generally takes about sixty days to complete.

Stages of Tax Credit Reservation

Federal law has stringent requirements for making allocations and placing projects in service. A slip in timing could cause the state to lose credits and not be able to access unused credits from other states. It is for this reason that the Committee has established progress requirements that ensure California is in compliance with federal law.

(1) Preliminary Reservation - Generally, when applications are submitted to TCAC, projects are not yet ready to begin construction and the applicant seeks a Preliminary Reservation. An applicant has 270 days from the date of reservation to meet all milestones for a Final Reservation and to commence construction.

(2) Final Reservation - Project sponsors receive a Final Reservation when all conditions of the Preliminary Reservation have been met. The construction loan must be funded, permanent financing and any other financing required to complete the project must be committed, and a partnership agreement must be executed. A second feasibility analysis is completed. This reservation is in effect during the project's construction period.

(3) Carryover Allocation - An applicant may obtain a Carryover Allocation prior to or after a Final Reservation, depending upon the time constraints imposed by federal law. Currently, federal law requires that a Carryover Allocation be obtained if a project will not be placed-in-service in the same year the project receives a reservation. To qualify for a Carryover Allocation, an applicant must incur more than 10% of the project's anticipated basis upon completion by December 31st of the year of the Carryover Allocation. TCAC generally imposes an earlier deadline and requires applicants to purchase the land or execute a land lease. A financial feasibility analysis will also be performed before the allocation is made. Once a Carryover Allocation is made, project owners have until the end of the second calendar year after the year in which the Carryover Allocation is made to place the project in service.

(4) Issuance of Tax Forms - This is accomplished when conditions of the Final Reservation have been met and the project is placed in service. TCAC issues IRS Form 8609 (and the state Form FTB 3521A, if applicable) after performing a final feasibility and cost reasonableness analysis to determine the requisite amount of tax credits needed. The final analysis is based on an audited cost certification prepared by the owner's accountant. One tax form will be issued for each residential building in a project.

Before the tax forms are issued, the applicant must enter into a regulatory agreement with TCAC. This agreement is recorded against the land and holds the project owner to the specifications and characteristics of the project on which the tax credit reservation was awarded (rent and income restrictions, selection criteria, preference points and other requirements).

Compliance Monitoring

The Committee administers a compliance monitoring program involving all projects with an allocation of federal or state credits. Projects are monitored according to the requirements of Section 42, IRS regulations, and the terms of the regulatory agreement entered into between the owner and the Committee.

Farmworker Housing Assistance Program

Recognizing the urgent housing need for agricultural workers, the legislature enacted the Farmworker Housing Assistance Program ("FHAP"). The program is authorized by Health and Safety Code Section 50199.51, Revenue and Taxation Code Sections 17053.14, 23608.2 and 23608.3. TCAC is currently authorized to allocated tax credit under the FHAP in the amount of $500,000 annually.

The FHAP provides owners who rehabilitate existing, or construct new, farmworker housing may receive a credit against their state income tax in an amount equaling 50% of the costs of rehabilitation or construction. The program also provides a credit to Lenders providing below market-interest rate loans to finance the construction or rehabilitation of farmworker housing. Banks or financial corporations are eligible for a tax credit in an amount equal to 50% of the difference between the market-rate interest income and the amount of interest charged for the farmworker housing project at a reduced interest rate.

In order to obtain the credit, owners and lenders must submit an application to TCAC, prior to the payment or incurrence of costs or funding of the loan, that provides information regarding the proposed project. Such information will include, but not be limited to:

- project ownership structure;
- project location;
- project sources and uses;
- project operating income and expenses;
- financing information and loan amortization schedules.

Eligible types of housing include multi-family dwellings, single family dwellings, mobile homes, or prefabricated housing. Farmworkers need not be employed by the owner of the farmworker housing project. Family projects, where all units are two-bedroom or larger will receive preference under the program. Occupants of the housing assisted by the FHAP must be farmworkers.

TCAC evaluates and ranks applications according to criteria set forth in its regulations. Criteria by which applications will be ranked include: readiness as determined by the amount of financing committed; and cost efficiency as determined by the total project cost per square foot. The amount of equity contributed in relation to the amount of credit requested will serve to break any tie between equally ranked projects.

Owners and lenders will be allowed tax credit in an amount determined by TCAC based on certified costs once the project is placed-in-service. TCAC will issue TCAC form 3531B, certification of credit. Owners may apply the credit against the current year's tax liability. If the credit received by the owner exceeds the owner's liability, the excess credit may be carried over and used in subsequent years. Credit received by lenders will be allowed in equal installments over a 10-year period. If the credit exceeds the liability, the excess may not be carried over into future years.

Farmworker housing owners receiving an allocation must agree to enter into an agreement with TCAC which provides that the housing produced under the program will be maintained as farmworker housing for a period of 30 years.